

BEFORE THE
COMMISSION ON STATE MANDATES
STATE OF CALIFORNIA

IN RE TEST CLAIM ON:

Government Code Sections 27 130, 27 13 1,
27132, 27132.1, 27132.2, 27132.3, 27132.4,
27133, 27134, 27135, 27136, 27137, as added
or amended by Statutes of 1995, Chapter 784
and Statutes of 1996, Chapter 156.

Filed on January 3 1, 1997;

By the County of San Bernardino, Claimant.

No. 96-365-03

County Treasury Oversight Committees

STATEMENT OF DECISION PURSUANT
TO GOVERNMENT CODE SECTION
17500 ET SEQ. ; TITLE 2, CALIFORNIA
CODE OF REGULATIONS, DIVISION 2,
CHAPTER 2.5, ARTICLE 7

(Adopted on July 27, 2000)

STATEMENT OF DECISION

The attached Statement of Decision of the Commission on State Mandates is hereby adopted in the above-entitled matter.

This Decision shall become effective on July 28, 2000.



Paula Higashi, Executive Director

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COMMISSION ON STATE MANDATES
STATE OF CALIFORNIA

IN RE TEST CLAIM ON:

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(Adopted on July 27, 2000)

STATEMENT OF DECISION

The Commission on State Mandates (Commission) heard and decided this test claim on June 29, 2000 during a regularly scheduled hearing. Marcia Faulkner appeared for the County of San Bernardino; Allan Burdick appeared for CSAC SB 90 Service; and Veronica Chung-Ng, appeared for the Department of Finance.

The law applicable to the Commission's determination of a reimbursable state mandated program is Government Code section 17500 et seq., article XIII B, section 6 of the California Constitution and related case law.

The Commission, by a vote of 7-0, approved this test claim.

BACKGROUND AND FINDINGS

The test claim legislation was triggered by Orange County's 1994 bankruptcy filing. The major factor which triggered the bankruptcy filing was the manner in which the Orange County treasurer managed the county's investment pool. In Orange County, local agencies issued short-term tax and revenue anticipation notes (TRANOS).¹ Pursuant to Government Code section 53684, the local agencies then invested the proceeds from the notes in the Orange County investment pool. These proceeds were invested primarily in long-term securities to achieve higher yields. When local agencies needed to withdraw funds from the investment pool to repay short-term TRANOS the Orange County investment pool lacked the necessary liquidity since most funds were invested in long-term securities. Thus, this investment strategy caused local entities to experience fiscal shortfalls which ultimately led to Orange County's petition for bankruptcy.

¹ TRANOS allow local governments to cover cash flow deficits with short-term borrowing. They are repaid in the same fiscal year in which they are issued.

In response to the Orange County Bankruptcy, the Legislature created County Treasury Oversight Committees (Oversight Committees) under Government Code section 27130 et seq. (Stats. 1995, ch. 784, and Stats. 1996, ch. 156 .). The Oversight Committees were created as part of a series of legislative measures to facilitate a new public policy governing local government investments of surplus funds. One of the primary purposes for the creation of Oversight Committees was to prevent county treasurers from selecting investments that overlooked the fiscal needs of other local agency depositors. By requiring Oversight Committees, the legislature gave a voice to local agency depositors on how their surplus funds would be invested. The Legislature believed the creation of Oversight Committees would promote sound investment decisions that would meet the fiscal needs of all local agency depositors. To this extent, the Legislature supported the pooling of investments operated by the county, but wanted to design a more stable environment for investing. Specifically, the Legislature declared, in part:

“By pooling deposits from local agencies . . . the county treasuries operate in the public interest. ”² In addition, “Oversight Committees will promote the public interest by involving depositors in the management of their funds and by enhancing the security and investment return on their funds by providing a more stable and predictable balance for investment by establishing criteria for the withdrawal of funds. ”³

Specifically, the test claim legislation:

- Requires the creation of an Oversight Committee for the counties which invest surplus public funds. (Gov. Code, § 2713 1.)
- Defines the membership of the committee. (Gov. Code, § 27 132 .)
- Places various campaign, fiscal, and employment restrictions upon committee members. (Gov. Code, §§ 27132.1-3.)
- Declares that the meetings are open to the public and subject to the Ralph M. Brown Open Meetings Act. (Gov. Code, § 27132.4.)
- Requires the county treasurer to prepare an annual investment policy subject to review of the committee. (Gov. Code, § 27133.)⁴
- Requires an annual audit to ensure county treasurer’s compliance with Article 6. (Gov. Code, § 27134.)
- Provides funding of this program through county charges which may be included with those charges enumerated under Government Code section 27103. (Gov. Code, § 27135.)

² Government Code section 27 130.

³ *Ibid.*

⁴ The Commission recognized that costs associated with the preparation of annual statements of investment policy are already being reimbursed under *Investment Reports* (CSM 96-358-03).

- z Requires the county treasurer to evaluate and approve any withdrawal of funds for the purpose of investing or depositing outside the investment pool. (Gov. Code, §§ 27136-37.)

FINDINGS

In order for a statute, which is the subject of a test claim, to impose a reimbursable state mandated program, the statutory language must direct or obligate an activity or task upon local governmental entities. Further, the required activity or task must be new or it must create an increased or higher level of service over the former required level of service. To determine if a required activity is new or imposes a higher level of service, a comparison must be undertaken between the test claim legislation and the legal requirements in effect immediately before the enactment of the test claim legislation. Finally, the newly required activity or increased level of service must be state mandated?

As indicated above, the test claim statutes require the establishment of Oversight Committees for counties wishing to invest surplus public funds. Oversight Committees are established to advise the county treasurer in the management of local government investments and, thus, carry out a basic governmental function by providing a service to the public. Such activities are not generally imposed on state residents. Therefore, the Commission found that the first requirement necessary to determine whether the Legislature had imposed a reimbursable state mandated program was satisfied.

The Commission continued its inquiry to determine if the test claim legislation constituted a new program or higher level of service and whether these activities were mandated by the state. The analysis of these issues for the statutes at issue is discussed below:

Issue 1:

Does the test claim legislation, which requires the establishment of a County Treasury Oversight Committee for counties investing public funds, constitute a reimbursable mandate within the meaning of section 6, article XIII B of the California Constitution and Government Code section 175 14?

Prior to 1995, counties were not required to create and operate Oversight Committees to invest public funds. If such Oversight Committees existed, it was at the discretion of the county and county treasurer. Now, after enactment of the test claim legislation, counties which invest surplus funds are required to establish Oversight Committees. The Commission found that Oversight Committees constitute a new program or higher level of service. Thus, the next issue addressed was whether Oversight Committees are state mandated.

As indicated above, the test claim statute requires the establishment of an Oversight Committee if a county wishes to invest public funds. Claimant argued that the establishment of Oversight Committees is mandatory when the practicalities of local government money management and investing are considered. Claimant referred to Government Code section 53638 which imposes

⁵ *County of Los Angeles v. State of California* (1987) 43 Cal.3d 46, 56; *Camel Valley Fire Protection Dist. v. State of California* (1987) 190 Cal.App.3d 521, 537; *Lucia Mar Unified School Dist. v. Honig* (1988) 44 Cal.3d 830, 835.

various restrictions on the amount of moneys a local entity may deposit in any one bank.⁶ Generally, this section establishes maximum deposit limits based on a financial institution's shareholder equity, net worth, amount of unimpaired capital and surplus, and amount of depository insurance. Based on these restriction, claimant asserted, if all local entities attempted to deposit surplus funds in the available financial institutions, there would be a shortage of banks able to accept funds from local agencies. Under these circumstances, local agencies would have no other option but to invest their surplus funds. Therefore, claimant maintained counties are required to invest surplus funds under their control.

In addition, claimant argued that the county treasurer, as a fiduciary, is required to safeguard the principal, meet liquidity needs, and achieve a return on the funds under his or her control. Therefore, it was claimant's position that as a practical matter, local agencies are, and always have been required to invest surplus funds. Under the circumstances, it was the claimant's position that counties are compelled to create Oversight Committees.

Originally, the Department of Finance (Department) argued that the claimant was not required to establish an Oversight Committee. Rather, it was the Department's position that claimant had the option of depositing public funds into a financial institution for safekeeping. The Department asserted that claimant had not established an inability to place funds with a bank under Government Code section 53638. Therefore, the Department concluded that investing excess funds is at the sole discretion of the county, and, as such, counties are not entitled to state subvention for the costs associated with establishing Oversight Committees.

However, in response to the issuance of the draft staff analysis, the Department changed its position and agreed that it is reasonable to conclude that claimant is required to invest a portion of its surplus funds. Therefore, all parties are in agreement that counties are required to establish an Oversight Committee when investing surplus funds.

The Commission found that it was not necessary to address claimant's proposed hypothetical regarding a banking shortage. Whether such an event would even occur is debatable. However, for the reasons set forth below, the Commission found that counties are required to establish an Oversight Committee when investing surplus funds.

First, under the test claim legislation, counties are directed to establish Oversight Committees to invest surplus public funds. The Commission assumed, based on the circumstance under which the legislation was enacted, that most, if not all counties were investing public funds prior to, during, and after the enactment of the test claim legislation. The test claim legislation did not provide "grand-fathering" or phase-in clauses for counties with ongoing investments. Counties holding investments, especially long-term investments which could not be immediately liquidated, were unable to alter investment strategies to avoid the requirements imposed by the test claim legislation. Thus, the Commission found that counties had no other option but to establish an Oversight Committee.

⁶ At the time the test claim legislation was enacted there were further restrictions on bank deposits made by local governments. Specifically section 856 of the Financial Code provided that California banks were not to have deposits from local government in excess of 400 percent of the entire shareholders' equity and that deposits of surety bonds should not exceed the amount of the bank's entire contributed capital. This section was repealed in 1996 (Stats. 1966, ch. 1063).

Second, Government Code section 27000.3, enacted under the same bill as the test claim legislation, declares that a county board of supervisors or county treasurer is a fiduciary, subject to the prudent investor standard. Specifically, Government Code section 27000.3 provides :

“(a) With regard to county funds deposited in the county treasury, the board of supervisors . . . or county treasurer shall be the agent of the county with respect to these funds, *serve as a fiduciary, and be subject to the prudent investor standard* and the board of supervisors shall not be the agent, serve as a fiduciary, or be subject to the prudent investor standard. ”

“(b) With regard to funds deposited in the county treasury that are deposited by local agencies other than the county and at the discretion of those local agencies, *the county treasurer serves as a fiduciary subject to the prudent investor standard.* ”

“(c) When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the county treasurer or the board of supervisors, as applicable, *shall act with care, skill, prudence, and diligence under the circumstances then prevailing, specifically including, but not limited to, the general economic conditions and the anticipated needs of the county and other depositors, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the county and the other depositors.* Within the limitations of this section and considering individual investments as part of an overall investment strategy, investments may be acquired as authorized by law . . .” (Emphasis added.)

In addition, the Commission noted that the county treasurer’s role is one of trustee in regards to local agency depositors who place funds with the county.⁷ The court in *Van de Kamp v. Bank of America National Trust & Savings* (1988) 204 Cal.App. 3d 8 19, noted that a trustee has an obligation to maximize trust income by prudent investment. The *Van de Kamp* court found merely depositing the money and receiving only 4 percent interest does not meet that obligation.⁸ Moreover, the court in *Estate of Pelton* (1982) 132 Cal.App. 3d 496, 499 held:

“When a fiduciary, over a long period of time, retains as an investment a bank deposit, without ascertaining or considering the advisability of other forms of investment productive of greater return of income and an equal degree of safety of principal, then such trustee by his non-action and passive course of conduct is negligent. . . . ”

⁷ Government Code section 27000.1

⁸ Citing, *Cheyenne-Arapaho Tribes of Okl. v. United States* (1975) 512 F.2d 1390, 1394; *Band of Porno Indians, Inc. v. United States* (N.D.Cal. 1973) 363 F.Supp. 1238, 1247.

Finally, under Government Code section 27000.5, also enacted by the test claim legislation, the county treasurer is specifically required to achieve a return on the funds.⁹ This can only be accomplished by investing, which triggers the requirement of the test claim legislation to establish an Oversight Committee. While the Commission did not dispute that some funds may be deposited into a financial institution for safekeeping and liquidity needs, the prudent investor rule requires reasonable diversification.¹⁰ Such diversification requirements would make it necessary for the county treasurer to invest at least a portion of the funds under his or her control. Otherwise, the county treasurer would not meet his or her fiduciary obligation to maximize trust income. Therefore, the Commission found that the obligation to establish and administer an Oversight Committee is not a discretionary undertaking, but is required under the test claim legislation.

Based on the foregoing, the Commission agreed with claimant's position. The county treasurer does not have the option to merely deposit surplus funds; the county treasurer must invest as a prudent investor. The Commission maintained a prudent investor should invest his or her funds, and not merely deposit them into a financial institution. The Commission found that by simply depositing funds instead of investing, a county treasurer would be deemed negligent for failure to produce a greater return of income. Thus, the Commission found that since county treasurers are compelled to invest public funds, counties are required to establish and administer Oversight Committees. Accordingly, the Commission found that the test claim legislation, which requires the establishment of a County Treasury Oversight Committee for counties investing public funds, constitutes a reimbursable mandate within the meaning of section 6, article XIII B of the California Constitution and Government Code section 175 14.

Issue 2:

Is the Commission prohibited from finding costs mandated by the state under Government Code section 17556, subdivision (d)?

Government Code section 17556, subdivision (d) provides in pertinent part:

“The Commission shall not find costs mandated by the state, as defined in section 175 14, in any claim submitted by a local agency or school district, if, after hearing, the commission found that:

“(d) The local agency or school district has the authority to levy service charges, fees, or assessments sufficient to pay for the mandated program or increased level of service. ”

⁹ “When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, *the primary objective* of the county treasurer or the board of supervisors, as the case may be, *shall be to safeguard the principal of the funds* under the treasurer's or the board's control. The *secondary objective* shall be *to meet the liquidity needs* of the depositor. The *third objective* shall be *to achieve a return on the funds* under his or her control. ” (Emphasis added.)

¹⁰ *Estate of Collins* (1977) 72 Cal.App.3d 663, 670.

The Department argued that Government Code section 17556, subdivision (d), specifically prohibits the Commission from finding costs mandated by the state whenever the local agency or school district has the authority to levy service charges, fees, or assessments sufficient to pay for the mandated program or increased level of service. The Department asserted that Government Code sections 27 135 and 27013 grant such authority to county.

The Claimant asserted that Government Code section 27013 does not provide the county fee authority to pass the costs of an Oversight Committee onto other local agency depositors. Claimant maintained this position based on the county treasurer's fiduciary duty to local agency depositors and its statutory interpretation of Government Code section 27013.¹¹ Claimant asserted that had the Legislature intended counties to have fee authority, it would have specifically amended Government Code section 27013 to include fees for Oversight Committees. Since the Legislature did not amend Government Code section 27013, claimant asserted, counties are precluded from using their fee authority to pass on the cost to other local agency depositors. Otherwise, the county would be liable for the treasurer's breach of fiduciary duty for charging a fee not specifically authorized by statute.¹² Therefore, claimant concluded that it should be reimbursed for the full cost associated with the administration of an Oversight Committee.

The Commission rejected claimant's assertion. Rather, the Commission found that counties are authorized to charge cities and school districts for the administration costs of the Oversight Committees pursuant to Government Code sections 27013 and 27 135. Specifically, Government Code section 27 135 provides :

“The cost of complying with this article shall be county charges and may be included with those charges enumerated under section 27013. ”

Government Code section 27013, enacted in 1963, provides:

“Notwithstanding any other provision of law, any treasurer, or other authorized county officer, who invests, deposits or otherwise handles funds for public agencies for the purpose of earning interest or other income on such funds as permitted by law, *may deduct from such interest or income*, before distribution thereof, the actual administrative cost of such investing, depositing or handling of funds and of distribution of such interest or income. *Such cost reimbursement shall be paid into the county general fund.* ” (Emphasis added.)

With both of these statutes working in concert, the Commission found that counties have fee authority to charge local agency depositors, such as cities and school districts, for costs attributable to its Oversight Committee. The Commission then reasoned that Government Code section 17556, subdivision (d) applies. However, the Commission noted that the county, as a local agency depositor, must either bear a percentage of the fee in proportion to its ownership in the investment pool, or charge other depositors a percentage of the fee disproportionate to their ownership in the investment pool. The latter of which is contrary to

¹¹ June 29, 2000 Hearing Transcript, pages 38-40.

¹² June 29, 2000 Hearing Transcript, page 40.

law.¹³ In addition, during the June 29, 2000 Hearing, the Commission found that a county's proportional ownership in their investment pool includes the investments of special districts under the control of county boards of supervisors.^{14, 15} Thus, the Commission found that costs associated with a county's Oversight Committee may not be chargeable as fees to special districts, if in reality, special districts are entities of the county. Accordingly, the Commission concluded that a county's cost of establishing and administering an Oversight Committee is not entirely paid for under Government Code section 27 135 and section 27013, and thus, section 17556, subdivision (d) is not entirely applicable.

The Commission found that Government Code section 17556, subdivision (d), prohibits the finding of costs mandated by the state for costs chargeable as fees to other local agency depositors, since the fees partially pay for the mandated program. However, the Commission found that Government Code section 17556, subdivision (d), is inapplicable to the costs absorbed by the county, because such costs are not chargeable as fees to other local agencies.

However, the question remained as to whether local agencies, such as cities, which may be charged a fee by the county to cover the costs associated with an Oversight Committee, are entitled to state subvention.

Issue 3:

Are local agency depositors, such as cities, entitled to state subvention under section 6, article XIII B for any fees that may be assessed by a county for the administration of its Oversight Committee?

Claimant maintained that local agency depositors are eligible for reimbursement of fees assessed by a County Oversight Committee pursuant to Government Code section 27135. It was claimant's position that by allowing the counties to pass these costs onto other local agencies, the state indirectly imposed the costs for Oversight Committees on other local agency depositors.

The Commission found that claimant's assertions were based upon the erroneous conclusion that the test claim legislation requires all local agencies to place their excess

¹³ Government Code section 53684(b) provides that "[t]he county treasurer shall, quarterly, apportion any interest or other increment derived from the investment of funds pursuant to this section in an amount proportionate to the average daily balance of the amounts deposited by the local agency and district. Prior to distributing that interest or increment, the county treasurer may deduct the actual costs incurred by the county in administering this section in proportion to the average daily balance of the amounts deposited by the local agency. " (Emphasis added.)

¹⁴ At the June 29, 2000, Hearing, Ms. Marcia Faulkner, representing the County of San Bernardino, testified as follows:

"Staff . . . has identified that most of the depositors are voluntary, and I found out very recently . . . that most of the depositors in there are not voluntarily . . . at least in San Bernardino County, because we have 80 to a hundred special districts that are governed by the board of supervisors, and in those cases the county treasurer is, in fact, the de facto treasurer of those special districts. So those are no longer - or they have been clarified they are not voluntary depositors. " (June 29, 2000 Hearing Transcript, page 37.)

¹⁵ June 29, 2000 Hearing Transcript, pages 36, 49.

funds with the county for purposes of investment. This is not the case. There is nothing in the test claim legislation that requires cities or school districts to place excess funds with a county treasurer for investment purposes. Cities have always had several options at their disposal. Cities may invest their funds independently,¹⁶ or contract with the county to perform treasury functions for the city.¹⁷

Generally, school districts are required to deposit all funds received with the county treasurer.¹⁸ The county treasurer holds the deposited funds in trust, and such funds are credited to the school district's general fund.¹⁹ However, school districts may choose to leave their surplus funds with the county,²⁰ or alternatively, they may independently invest their own surplus funds.^{21, 22}

Thus, by voluntarily investing their funds with the county, cities and school districts have chosen to incur additional costs associated with Oversight Committees.²³ Accordingly, the Commission found that local agencies, voluntarily investing funds with the county, are not entitled to state subvention under section 6, article XIII B for any fees assessed for the administration of its Oversight Committee.

Assuming arguendo, for those local agencies voluntarily placing their surplus funds with the county, in order to be eligible for reimbursement for fees assessed by a County Oversight Committee, there must be a finding that the fees imposed by the county were mandated by the state. The leading case on point is *City of San Jose v. State of California* (1996) 45 Cal. App. 4th 1802. In this case, the issue was whether Government Code section 29550, which gave counties the discretion to charge cities and other local agencies for the costs of booking persons arrested by a city or other local agency into county jails, constituted a state mandate. The City of San Jose (City) contended that because the statute allowed counties to charge cities and other local agencies for booking fees, the statute imposed a new program under article XIII B, section 6. The City maintained that the *Lucia Mar*²⁴ decision governed the claim.

¹⁶ Government Code section 53601.

¹⁷ Government Code section 5 1301.

¹⁸ Education Code sections 41001 and 41002; *Yreka Union High School District v. Siskiyou Union High School District* (1964) 227 Cal.App.2d 666, 670-71; *citing* (Former Ed. Code §§17512-17204.)

¹⁹ *Ibid.*

²⁰ Government Code section 53684.

²¹ Education Code section 41015.

²² Government Code sections 16430 and 53601.

²³ Once the local agency funds are placed with a county's investment pool, the county treasurer becomes a trustee and invests such funds pursuant to Government Code sections 53601 and 53635.

²⁴ *Lucia Mar, supra* (1988) 44 Cal.3d 830, involved Education Code section 59300, enacted in 198 1. That section required local school districts to contribute part of the cost of educating district students at state schools for the severely handicapped *while the state continued to administer the program*. Prior to 1979, the school districts had been required by statute to contribute to the education of students in their districts who attended state schools. However, those statutes were repealed following the passage of Proposition 13 in 1978. In 1979, the

The *San Jose* court disagreed with the City's contention. The court held that the shift in funding was not from the state to the local agency, but from the county to the city and, thus, *Lucia Mar* was inapposite. The court stated:

"The flaw in the City's reliance on *Lucia Mar* is that in our case the shift in funding is not from the state to the local entity but from the county to the city."²⁵

The *San Jose* court further concluded:

"Nothing in article XIII B prohibits the shifting of costs between local governmental entities. (Emphasis added.)"

Claimant, in its response to the Draft Staff Analysis, attempted to distinguish the holding in *City of San Jose*, to support its position. It was claimant's position that, unlike the facts under *City of San Jose*, the charges for the costs of Oversight Committees were not ongoing, but imposed under the test claim legislation. Thus, claimant maintained that the holding in *City of San Jose* is not controlling.

Here, as in *City of San Jose*, the Commission found that the test claim legislation did not require the county to collect fees from the other local agencies. The test claim legislation merely authorized counties to collect fees from other local agencies. In addition, just as the City of San Jose had the option to avoid county charges by building its own jail for booking and holding arrestees, so do local agencies have the option of avoiding county charges by investing their funds independent of the county. Thus, the Commission found, that local agencies voluntarily placing their surplus funds with the county would not be entitled to state subvention under section 6, article XIII B for any fees assessed by a county for the administration of its Oversight Committee.²⁶

state assumed full responsibility for funding the schools. At the time section 59300 was enacted in 1981, the state had full financial responsibility for operating state schools. The California Supreme Court found that the primary financial and administrative responsibility for state handicapped schools rested with the state at the time the test claim statute was enacted. The court stated that "[t]he intent of [section 6] would plainly be violated if the state could, while retaining administrative control of programs it has supported with state tax money, simply shift the cost of the programs to local government. . . ." (Emphasis added.) Thus, the court found that, under the circumstances of the case, the transfer of financial responsibility from the state to local school districts imposed a new program under section 6.

²⁵ *City of San Jose, supra* (1996) 45 Cal.App.4th 1802, 1812.

²⁶ No local agency depositor whether a city, school district or special district, has presented evidence to the Commission that indicates **estimated or increased** costs associated with this test claim. Thus, the Commission is unable to address whether local agency depositors, required to invest with a county, are entitled to state subvention.

Conclusion

Based on the foregoing, the Commission found that the test claim legislation imposes a new program or higher level of service within an existing program upon counties within the meaning of section 6, article XIII B of the California Constitution and Government Code section 17514 by requiring the establishment of a County Treasury Oversight Committee in order to invest public funds. However, The Commission found that Government Code section 17556, subdivision (d), prohibits the finding of costs mandated by the state for costs chargeable as fees to other local agency depositors.

The Commission further concluded that, in accordance with *City of San Jose*, the test claim legislation does not impose a reimbursable mandate for fees assessed by a County Treasury Oversight Committee for local agencies voluntarily placing their funds with the county for investment purposes.